DOCUMENT RESUME

ED 284 632 JC 870 362

TITLE	Negotiating an Oil and Gas Lease. Teachers Instructional Packet, TIP No. 6, Spring 1985.
INSTITUTION	Texas A and M Univ., College Station. Texas Real Estate Research Center.
PUB DATE	85
NOTE	48p.; For other Teachers Instructional Packets in this series, see JC 870 357-372.
AVAILABLE FROM	Texas Real Estate Research Center, Texas A & M University, Blocker Bldg., College Station, TX 77843 ($2.00).
PUB TYPE	Guides - Classroom Use - Guides (For Teachers) (052)
EDRS PRICE	MF01 Plus Postage. PC Not Available from EDRS.
DESCRIPTORS	*Business Education; *Contracts; Fuels; Instructional Materials; *Land Use; Legal Responsibility; *Petroleum Industry; Postsecondary Education; *Real Estate; Real Estate Occupations; Teaching Guides
IDENTIFIERS	*Leasing; Natural Gas; *Texas

ABSTRACT

Part of a series of classroom aids designed for real estate instructors, this instructional packet was developed to help real estate students understand the more common provisions and the legal significance of an oil and gas lease, as well as some provisions landowners may wish to insert for personal benefit and protection. Following an evaluation form for the packet, a summary instructor's presentation on oil and gas leases is provided. This presentation includes information on: (1) the granting clause, which outlines the purpose of the lease and the substances that can be explored and produced; (2) limits and rights regarding surface operations; (3) the duration of the lease; (4) extension of the primary and secondary terms of the lease; (5) the royalty clause, which allocates to the landowner a certain portion of the substances produced; (6) surface damages; (7) "pooling," i.e., consolidating the leased premises with adjoining leased tracts; (8) the assignment clause, which permits both the lessor and the lessee the unrestricted privilege of assigning their rights under the lease; (9) the warranty clause, which binds the landowner to defend interest in, or title to, the leased premises; (10) the lessee's right to free water, oil, and gas; (11) the force majeure clause, which protects the oil companies from liability and loss of the lease whenever causes beyond their control suspend operations; and (12) other clauses for the landowner's consideration. Twenty-one overhead masters keyed to the presentation are provided. (EJV)

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TEACHERS INSTRUCTIONAL PACKET
TIP No. 6, Spring 1985

NEGOTIATING AN OIL AND GAS LEASE

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This packet is designed to help real estate instructors clearly communicate with students studying for real estate careers. The content and materials may be modified as the instructor deems appropriate. Reproduction of materials for student use is encouraged.

TIPS on the TIP

This Teacher Instructional Packet (TIP) is designed to provide the real estate instructor with classroom aids. Packets have been reviewed carefully, but there is always room for improvement. Suggestions to improve the usefulness of the TIP are welcomed.

Introduction to the TIP

TIP-6 has been developed to help students understand the negotiating an oil and gas lease in Texas. This material is provided as a **supplement** to existing course content. It is not a pat presentation. Instructors may use as much or as little as needed.

NOTE: Copies of the TRERC Technical Report, "Hints on Negotiating an Oil and Gas Lease," have been provided to Texas real estate instructors. Additional copies are available for $1 each ($2 for out-of-state orders). Ask for publication number 229. Instructors have permission to reproduce this report in full or in part providing no changes are made in the content.

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1. What overall rating would you give this concept?

useless 1 2 3 4 5 6 7 8 9 10 invaluable

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too general 1 2 3 4 5 6 7 8 9 10 too technical

Amount of material:

too little 1 2 3 4 5 6 7 8 9 10 too much

Format:

too simple 1 2 3 4 5 6 7 8 9 10 too complex

STRENGTHS AND WEAKNESSES

3. What were the strengths of the package? _____

_____

_____

_____

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_____

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HINTS ON NEGOTIATING AN OIL AND GAS LEASE

INSTRUCTOR'S SUMMARY

From the landowner's standpoint, the nation's energy crisis has produced a welcomed upsurge in the exploration for oil and gas. Properties once considered marginal or doubtful now are being sought for potential commercial production.

Before any exploration can begin, the landowner (lessor) and the oil company (lessee) must agree to certain terms regarding the rights, privileges and obligations of the respective parties during the exploration and possible production stages. The negotiation of these terms may be the landowner's first exposure to an oil and gas lease. Because of the legal nature of the leasing arrangement, the novice landowner may be at a disadvantage when dealing with an experienced lessee (oil company).

The purpose of this article is to acquaint non-experts with the more common provisions of an oil and gas lease and explain their legal significance. The article also will detail some provisions that the landowner may wish to insert for personal benefit and protection. However, the article will not serve as a substitute for legal counsel.

VISUAL #1
Landowner's Goals

No standard or universal lease form is used by the oil and gas industry. Instead, each company (or independent lessee) has a predrafted agreement that has proven suitable to them in the past. These agreements may not necessarily be in the best interest of the landowners.

VISUAL #2
Leases Are Negotiable

Landowners should remember that all provisions of a lease are negotiable. Even though the oil company representative or landman soliciting the lease may not have the authority to make changes, this does not mean certain

clauses, or the complete lease itself, may not be altered. However, the landowner's ability to negotiate more favorable terms will vary in each situation.

A. The Granting Clause

VISUAL #3
Granting Clause

The opening paragraph of most leases is the granting clause. It will outline the purpose of the lease and describe the substances that can be explored and produced. Typically, the clause will state that the lease is given for the purpose of exploring, drilling, mining and producing oil and gas and all other associated hydrocarbons in whatsoever nature or kind. More liberal leases state the agreement covers all other minerals and other gases and their respective vapors.

Two problems become apparent in Texas. First, if the substances sought should lie near the surface or will substantially damage the surface if produced, the substance may belong to the surface owner. (This will only create a problem where the mineral owner is not the respective surface owner). Secondly, if substances other than oil and gas or associated hydrocarbons are discovered, will the lease cover them?

There are no easy answers, but here are some suggestions to consider.

VISUAL #4
Surface Operations

1. To avoid any dispute between the surface and the subsurface owners, specify that the extraction method used by the lessee cannot strip away nor substantially destroy the surface. This arrangement may not always be economically feasible for the lessee. Still, landowners should realize all substances lying beneath the surface do not necessarily belong to the mineral owner.

2. Resolve any speculation as to the substances covered by the lease in

one of two ways. Either explicitly state the substances covered to the exclusion of all others, i.e., all petroleum and natural gas and related hydrocarbons except coal and valuable stones. Or alternatively, amend the royalty clause (see section E) to list the percentage share the landowner will receive for the production of all substances that might be discovered in commercial quantities. For instance, the landowner may wish a greater share for the production of uranium or helium than for carbon dioxide or sulphur. The lessor might even insert an arbitration clause if no present agreement could be reached on the differing percentages.

B. The Granting Clause and Surface Operations

With few exceptions, the grant of an oil and gas lease carries with it the implied right to use as much of the surface area as is reasonably necessary to explore and produce the oil and gas. Most leases expand upon these implied rights and explicitly permit a much wider range of surface activities.

Even though the lessee may be liable for surface damages (see section F), the inconvenience of unwanted and unwarranted structures and entries upon the surface area by the lessee may be avoided to some degree through negotiation of the following:

1. Do not grant the unrestricted right to construct permanent facilities such as power stations, storage tanks or employees' quarters. Also, do not grant an unrestricted right for the surface disposal of salt water if valuable agricultural land is to be preserved. Instead, state that prior written consent of the lessor is needed for both the construction and location of such structures and sites.

VISUAL #5
Limiting Surface Operations

2. Alternatively, attach a map of the proposed lease area specifying where roads, pipelines, telephone lines, salt water disposal sites and even wells may be located. For convenience sake, landowners generally do not permit wells within 200 feet (or some other stipulated distance) of a dwelling. Further, provide that all underground transmission devices such as pipelines and telephone lines must be buried below plow depth (or a specified depth) in agricultural areas. If deviations are necessary, permit them only after securing the lessor's written consent.

3. Landowners wishing to cultivate or graze the area immediately above any pipelines should direct the lessee to use the double ditch method for laying pipe. This method requires the top soil be placed on one side of the trench and the subsoil on the other. When backfilling, the subsoil is replaced first followed by the top soil.

4. Specify whether the lessee's structures and equipment must be removed at the expiration of the lease or be forfeited.

5. Identify the parties liable for the construction and maintenance of fences and gates or similar structures around the premises, pits, drilling sites and above intersecting pipelines. The precise dimensions and characteristics of the fences and gates may need to be included.

C. The Duration of the Lease

Leases are divided into two separate time periods. The first period, or primary term, is a set number of years negotiated by the parties

VISUAL #6
Duration Clause

during which drilling operations must begin or delay rentals must be paid. The lease will generally state that if drilling operations are not commenced within one year after the lease is entered, the lease will terminate unless an agreed sum is paid the lessor. This sum is called a delay rental. Delay rentals must be paid on each subsequent anniversary date of the lease's primary term if drilling operations have not yet begun by that date.

Failure to receive the delay rental payment by the stipulated time automatically terminates the lease whenever the word "unless" is used to indicate the necessity of tendering the payment. Some leases contain the word "or" rather than "unless." In the latter case the lease will not terminate for a delinquent payment.

If production is not established by the end of the primary term, the lease will end. If production has been established, the lease will continue into its secondary term and last so long as substances covered by the lease continue to be produced. Generally the full clause will read, "This lease shall remain in force and effect for a term of _____ years (or months) and as long thereafter as substances covered by the lease are produced."

For the best protection, the lessor can consider one or more of the following recommendations:

1. Strive to keep the primary term as short as possible. This should force earlier explorations.

2. If the primary term cannot be shortened, strive to negotiate a higher annual delay rental payment.

3. Make sure the word "unless" is employed. Avoid using the word "or." Keep a watchful eye on the date by which the delay rental payments must be received.

Acceptance of a late payment may be construed as a ratification, and the lease will not terminate.

4. Stipulate that with any payment the lessee must identify the governing lease and the provisions necessitating the payment. This is an invaluable aid for landowners trying to keep track of several different leases on their land.

D. Extension of the Primary and Secondary Terms

The primary and sometimes the secondary terms of the lease may be extended contractually via the shut-in provisions, dry-hole provisions or cessation of production provisions. Most leases will contain all three.

The shut-in provisions allow the lease to remain in effect (sometimes during both the primary and secondary terms) whenever the gas from a producing well is not, for some reason, being sold or used by the lessee. In other words, a well that is shut-in is still classified as a producing well under the lease provisions, and the lease will not terminate. Even so, a shut-in royalty (or some other stipulated sum generally approximating the value of the delay rental payment) must be paid annually to keep the lease in effect.

VISUAL #7
Shut-In Provisions

The dry-hole provisions, on the other hand, will extend the primary term of the lease but only in certain instances. Basically the lease will provide that if oil or gas has not been discovered when a dry hole is struck, the lease will not terminate even though the primary term has expired if the lessee renews drilling or re-working operations with 60 days (or some other stipulated period) thereafter. In the event the primary term has not expired and more than 14 months still

VISUAL #8
Dry-Hole Provisions

remain, the lessee has two other options available. He or she can either pay the next delay rental payment which comes due more than 60 days after the dry hole was discovered or commence drilling or re-working operations on or before the same date. (The 60-day period and 14-month period vary with different leases).

If less than 14 months remain in the primary term when the dry hole is discovered, the lease will continue in force to the end of the primary term even though the lessee operations remain idle and no delay rentals are paid.

The cessation of production provisions correspond quite closely to the dry-hole provisions. The main difference is that the cessation-of-production rules apply only after oil and gas have been discovered. Here the lease provides that if oil and gas production should cease for any reason, the lease will not terminate if the lessee again follows one of the three options described in the dry-hole provisions.

VISUAL #9
Cessation of Production Provisions

Interestingly, it is quite possible for the lease term to be extended indefinitely via the dry-hole provision or the cessation-of-production provisions. If the lessee has discovered oil or gas or if a dry hole has been discovered, the lease will continue in force for so long as the lessee faithfully renews drilling or re-working operations within 60 days after either event occurs.

Most landowners do not have too much quarrel with the dry-hole and cessation-of-production provisions since in both cases oil and gas are being sought diligently. However, landowners may have difficulty accepting the shut-in provisions, especially where no apparent reason exists for the harboring of gas or possibly oil.

Because of the energy shortage and the high cost of bringing a well into production shut-in provisions are used rarely. Even so, landowners may wish to consider the following alternatives to clarify their possible usage.

VISUAL #10
Shut-In Clause

1. Make sure shut-in royalties are required during both the primary and secondary terms of the lease.

2. Place a maximum number of years on the shut-in clause--i.e., no more than three years or three years beyond the primary term.

3. Escalate the shut-in royalty for each year the gas or oil is shut-in.

4. As an alternative, permit the shut-in to continue after a stated period but only for a given number of acres immediately surrounding the well--i.e., 160 acres. The rest of the leased area will revert to the lessor-landowner. (This provision may be qualified depending on the reasons for the shut-in).

5. Always phrase the necessity of making the payments under the shut-in provisions in optional terms (may or can) and not in obligatory terms (shall or will). There is some legal precedence to the effect that a breach of the former terminates the lease whereas a breach of the latter does not. The only recourse left to the landowner in the latter case is to sue the producer for breach of contract.

6. Specify the circumstances when the shut-in clause may be invoked--i.e., for lack of market, available pipeline or government restrictions. As a possible alternative, permit the shut-in when, in the lessee's good faith judgment, it is economically inadvisable to produce and sell for

the time being. In light of this latter suggestion, one may wish to extend shut-in provisions to both oil and gas.

7. Automatically terminate the shut-in provision whenever a well located on adjacent land, situated within a certain number feet of the leased premises, and completed within the same producing reservoir begins producing and selling gas in marketable quantities.

E. The Royalty Clause

VISUAL #11
Negotiating the Royalty Clause

Each lease contains a paragraph which allocates to the landowner a certain portion of the substances produced. These allocations may be stated in terms of market price or value, proceeds, or in kind. This is the royalty clause. From an economic standpoint, it is probably the most important clause to the landowner.

The terms of royalty clauses vary greatly from lease to lease. Through the evolution of court cases, some of the confusion surrounding this clause has been eliminated in Texas. However, several factors still should be considered by the landowner.

First, specify which costs, if any, can be deducted from the landowner's royalty payment. The costs encountered throughout the exploration, drilling, production and marketing stages are divided into two categories: (1) those borne solely by the oil company (producer) and (2) those shared by the landowner.

Generally all expenses encountered up through the production stages are borne solely by the oil company. Expenses encountered subsequent to production can be either shared or borne solely by the oil company depending on the terms of the lease.

The shared expenses will depend partly upon where the lease fixes the royalty. If the lease is silent on this matter, the royalty is ascertained "at the well." In such cases, the landowner's royalty payment is free of production costs but certain costs subsequent to production are shared. If the lease fixes the royalty "in the pipeline," "at the place of sale" or at other delivery points, a different set of costs are shared. These costs may include such items as compression expenses necessary to make the product deliverable into the purchaser's pipeline, expenses necessary to make the product salable and the expenses used in measuring production.

Another problem that the landowner should consider is determining how the royalty payment is valued or received. Three methods generally are used.

VISUAL #12
Determing How Royalty Payment Is Valued or Received

The market price or value is based on the mineral's value as reflected by the marketplace, generally at the mouth of the well. In the past, if there was no market at the well, then the market price prevailing in the field was used. And if there was no field market, then the value was determined by sales of marketing outlets comparable in time, quantity, quality and availability. And finally, if there were no comparable sales, the actual or intrinsic value of the substance could be used.

The market price method has been quite popular with landowners because it allows the royalty to follow the upward price trend for oil and gas. However, there are some associated problems of which landowners should be aware when using this method.

Sometimes the prices posted at wells or fields are discriminatory, set artificially and substantially less than the prices paid for comparable minerals at other fields. In such cases, it may

be possible to get a higher valuation for the royalty payments but only after a difficult burden of proof has been met by the landowner in a judicial proceeding.

In a Texas appellate case, the court held that where valuation was based on market value at the well but did not provide a formula for determining market value, the phraseology means the prevailing market value at the time of sale, and the sale occurs at the time of delivery to the purchaser.

To avoid problems, insert some formula for determining how the market price or value will be established. For example, some leases read, "at the highest price (or percentage thereof) posted for a field within 100 miles by any of the seven major oil companies for like grade and gravity on the day the oil is removed."

The second means of evaluating royalty payments is by way of proceeds. This method bases the royalty upon the actual revenue derived from the sale of the mineral. As such, the resulting sales price may or may not equal the mineral's actual market value as discussed earlier. In the past, royalties based on proceeds have been very popular. This method gave greater flexibility to the producer in marketing the product, particularly gas. By committing gas to long-term contracts, the producer could insure the landowner of a constant, dependable royalty income over time. The disadvantage was that the resulting proceeds were not immediately sensitive to a rising market.

The third method of receiving royalties is "in kind." This method presents an excellent alternative for dealing with a lease based on proceeds. By inserting an option to take royalties either "in proceeds" or "in kind," the

landowner can get the best of both worlds. Whenever, the market price rises above any long-term commitment price, the landowner can take his or her share "in kind" and seek a market outlet. Whenever, the market price falls below any long-term commitment, the lessor's share can be taken in proceeds.

The in-kind, in-proceeds alternative is quite attractive to a landowner whenever one or more gas wells or pipelines are dedicated to the highly regulated interstate market. By the landowner opting to take royalty "in kind," the gas can be sold on the more lucrative intrastate market. As a general rule, lessees are hesitant about granting this option unless the lease is in a major producing field. Otherwise, the cost of storage, accounting, delivery and other associated expenses will outstrip any gains to the landowner.

Without belaboring any one point, the following is a list of factors that also might be considered when negotiating a royalty clause.

VISUAL #13
Additional Royalty Negotiations

1. Detail the time, place and frequency royalty payments are to be tendered. Outline the consequences for royalty payments being missed.

2. Discuss and resolve whether royalties should be paid for wastes due to leakage, fire or other reasons which can be attributed to the lessee's negligence.

3. Consider an extra royalty (or overriding royalty) based on a sliding scale with any one of several items as variables. For example, have one royalty based on daily or monthly production of less than "x" barrels per day (or month) and another whenever production exceeds this level. Other

variables upon which the scale could be based include such things as whether the substance is free flowing or having to be lifted by artificial means, the price of crude oil in the event domestic price controls are eliminated, or even upon the lessee's recoupment of all or a certain percentage of the production cost from the well. (Note: The last alternative is probably the most viable one.)

4. Determine if and when the landowner should have access to free gas. Many leases allow the lessor the free use of gas for domestic (and sometimes agricultural) purposes.

5. By the same token, decide whether the lessee should have free use of water, oil and gas produced on the leased premises. (See section J for further details.)

6. As mentioned in prior sections, do not forget to include differing royalty percentages for substances other than oil and gas which might be discovered.

F. Surface Damages

The granting of an oil and gas lease carries with it the implied right to use as much of the surface area as is reasonably necessary for the development of the mineral interest. Only when the lessee goes beyond what is reasonably necessary or negligently injures the surface area will the lessee become liable for damages to the holder of the surface estate. Likewise, the lessee is under no legal obligation to restore the surface area to its condition prior to the commencement of operations.

For better protection, the landowner can insert some provisions in the lease pertaining to surface damages. For instance, a lease clause

requiring compensation for all surface damages will render the lessee liable even though the damages were incurred during the reasonable development of the mineral lease.

When compensation is required, it is commonly made "at the site" when drilling or production operations cease. To avoid any conflicts in this matter, the landowner should consider the following clauses whenever negotiating the lease.

VISUAL #14
Clarification of Surface Damages

1. Require compensation for all surface damages.

2. If possible, require the lessee to restore the land to its condition prior to any operations.

3. Describe the method or methods to be employed for determining the extent of damages suffered. In the event the parties cannot agree, provide for arbitration or some other means of resolving dispute.

4. Describe the items for which the lessee will be liable -- i.e., injuries to growing crops, and timber, pastures, livestock, fences, ditches, buildings and other structures and the pollution of waters or the erosion of soil.

5. Determine if the compensation will be paid annually or in a lump sum. In part, this decision will depend on whether the damages are temporary or permanent in nature.

6. Resolve beforehand how payments will be distributed among the respective owners of the surface estate. This problem mainly arises whenever there is an agricultural lessee on the premises.

7. Designate the time period by which all claims or notices must be submitted to the lessee.

8. Possibly require a bond or an advance payment as security for claims against future surface damages.

G. Pooling

Most leases will contain some provision giving the lessee the right to consolidate the leased premises with adjoining leased tracts. The area thus formed is called a "pool" or sometimes a "unit." The rationale for establishing such pools is to unite under one operator all the landowners having an interest in a common underground reservoir. By doing so, the lessee avoids unnecessary drilling, protects the rights of the landowners in the common reservoir and prevents waste. Sometimes pooling arrangements are necessary to meet the minimum acreage requirement for a drilling permit under Rule 37 of the Texas Railroad Commission.

In Texas, landowners may be subjected to two types of pooling arrangements. One is voluntary; the other is compulsory or statutory. The voluntary arrangement requires the free consent of the landowner and is generally found in the context of most lease forms. The statutory arrangement, on the other hand, is mandatory whenever the requirements specified in Section 102 of the Texas Natural Resource Code have been met. By entering either type of pooling arrangement, the landowner may find the interpretation and application of the lease provisions materially altered.

Obviously, there is very little the landowner can do to avoid compulsory or statutory pooling. But, the landowner may find it advisable to exercise caution in granting the lessee the unrestricted right to pool the leased premises. The following negotiable points may be helpful in this regard.

VISUAL #15
Pooling Clause-Voluntary Pooling

1. If necessary, submit to voluntary pooling in the lease only to the extent necessary to meet the drilling permit requirements under Rule 37. (Presently a minimum of 40 acres generally is required for both oil and gas.) Otherwise, the landowner's written consent should be required to pool. Do not consent until the landowner understands the full impact of the pooling arrangement on the lease terms, the full description of the proposed pool area and the details on how the boundaries were determined.

2. To keep a pool from being overly extensive, stipulate in the lease the maximum number of acres a pool may contain. As a rule of thumb, limit the acreage to no more than that specified in the Texas statutory pooling provisions which is approximately 160 acres for an oil well and 640 acres for a gas well plus 10 percent tolerance for each.

3. Give some thought as to whether the lessee may alter or change the size or shape of the proposed pool after the landowner has consented.

4. Consider whether the pool is limited to certain producing strata or given for any and all producing formations which may be encountered. Also consider which substances may be pooled -- i.e., oil and gas but not coal, valuable stones or other gaseous substances.

5. In all cases, try to negotiate the inclusion of a "Pugh" clause in the lease. A Pugh clause provides for the severance of the lease into separate tracts whenever less than all of the premises are included in a single pool or unit.

   A typical Pugh clause will read, "Upon the pooling of less

than all of the leased land, this lease shall be severed and considered as separate and distinct leases. The lease term and all the rights and obligations of the lessee under this instrument shall apply separately to the pooled and unpooled acreage."

Without a Pugh clause, leases generally have language that extends the "leased premises" to all areas pooled with the original tract. Thereafter, if production, drilling or re-working operations are commenced on any portion of the pool (whether on the original leased tract or not), they will be construed as being undertaken on the leased land.

CAUTION

By including a small area of a large lease tract in a pool, the lessee can effectively eliminate the need for tendering delay rentals, reduce the proportionate share of royalties to the respective landowners and still maintain the full lease by drilling and establishing production on any part of the pooled area.

6. If possible require all pooling to occur prior to drilling operations and not afterwards.

H. Assignment Clause

Typically, leases contain a provision permitting both the lessor and the lessee the unrestricted privilege of assigning their rights under the lease. To a large extent these provisions are for the lessee's benefit.

A customary practice in the oil and gas industry is for independent landmen to lease a large area and assign (sell) it to an oil company. Consequently, the

ultimate developer-producer may not necessarily be the original lessee. At times the landowner may find the original lease tract being subdivided among several developers. To keep better apprised of such changes, the landowner may seek to incorporate some of the following suggestions.

1. Deny the right of assignment without first securing the landowner's written consent. If this is not feasible, state that any assignment is not binding upon the lessor until he or she is duly notified in writing. In either case, the landowner should keep a permanent record of each new assignee for his or her files.

VISUAL #16
Assignment Clause

2. Do not release the original lessee from liability for a default on any assigned portion of the lease or leased area. Stipulate a default on any assigned part of the lease is a default on the whole.

3. Provide that accompanying each payment there must be an identification of the governing lease (or assignment thereof) and the provisions of the lease for which payment is being tendered.

I. Warranty Clause

Leases generally will contain provisions binding the landowner to defend interest in, or title to, the leased premises should a dispute ever arise over ownership. This is known as the warranty clause.

VISUAL #17
Warranty Clause

To avoid any possible litigation expenses, landowners should seek to delete any language which infers they will warrant or defend title to the land. Since most oil companies or landmen generally conduct preliminary investigations as to the ownership of mineral interest prior to any lease negotiations, the warranty clause may not be necessary anyway.

J. Lessee's Right to Free Water, Oil and Gas

Landowners should pay close attention to any provisions in a lease providing free water, oil or gas to the producer for operations. Particularly in areas where water is scarce, certain limitations should be placed on these rights. The following suggestions may be helpful.

1. Decide whether free water, oil or gas privileges should be granted to the lessee. If so, stipulate whether the substances may be used for operations conducted both on and off the leased premises. (These provisions may be incorporated into the royalty clause as mentioned earlier.)

2. If the land should contain a central supportive device, such as an oil-gas separator, pro rate the free use of oil and gas needed to run the separator according to the amount of production on the land.

3. Restrict water taken by the lessee from wells, tanks, ponds or reservoirs.

4. Stipulate any water use by the lessee cannot diminish the supply of water for domestic, livestock or agricultural purposes.

5. If recovery measures are undertaken by the lessee involving waterflood operations, deny the use of potable water. State that such water must come from non-fresh sources.

6. If water is to be purchased, state how the market price will be determined.

VISUAL #18
Lessee's Right to Oil, Gas and Free Water

K. Force Majeure Clause

With increasing frequency, leases contain provisions which protect the oil companies from liability and loss of the

lease whenever causes beyond their control suspend operations. This is known as the force majeure clause. Because of the clause's recent vintage, very few court interpretations have emerged. However, there are some factors the landowners may wish to consider whenever this clause is proposed in a lease.

1. Avoid the inclusion of the words "force majeure." Its legal meaning remains too clouded.

VISUAL #19
Force Majeure Clause

2. Limit the clause to simple terms. For instance, state, "if drilling, working or production operations are delayed or interrupted for specific causes..."

3. Require a timely written notice any time a sustained work stoppage occurs. Have the notice specify whether the stoppage was pursuant to causes beyond the lessee's control, the shut-in, the dry-hole or the cessation-of-production provisions of the lease. Furthermore, have the notice contain supportive evidence for the lessee's reliance on the particular provision.

4. If an unavoidable stoppage should occur during the primary term of the lease, decide whether delay rental payments are due and whether the lease term will be extended for the period of the delay.

5. Also, determine the time frame in which operations must resume once the cause is removed.

L. Other Clauses for the Landowner's Consideration

Without going into detail, the following clauses may be considered by landowners when negotiating a lease.

1. If the land contains several producing formations at varying

VISUAL #20
Additional Negotiable Clauses

depths, lease each strata independently.

2. Note in the lease whether the land can be used for underground storage of gas or oil.

3. Insert provisions allowing free access to books, records and drilling data accumulated pursuant to operations conducted on the landowner's premises.

4. If possible, negotiate some provisions whereby the landowner may assume control of the casing in the borehole when operations are abandoned. The casing could be used to withdraw any remaining gas or extract fresh water for domestic or agricultural purposes. However, the landowner may be required to assume the cost and liability for plugging the well in some jurisdictions.

5. Provide that if lessee does not rectify any breach of a covenant contained in the lease within 30 days after lessor gives written notice, the lessee should pay reasonable attorney fees and reasonable investigative costs incurred by lessor in preparing lessor's case for trial or pay a specified amount of liquidated damages.

6. Require lessee to indemnify, save and hold lessor harmless from all claims, demands and causes of actions stemming from activities undertaken by lessee or lessee's assignees, their employees, agents, contractors and subcontractors during operations conducted on the leased premises. If possible, require the lessee to post bond and carry comprehensive liability insurance of a specified amount as added security from such claims.

Conclusion

Negotiating an oil and gas lease requires legal knowledge, foresight and common sense. This article has attempted to apply all three.

VISUAL #21
The Final Agreement

No landowner could possibly hope to have all these clauses included in a lease. The number successfully incorporated depends largely upon negotiating power. Even so, the information contained herein will enlighten the landowner as to some possible alternatives, and, if nothing else, foster frank discussion between the landowner and the lessee prior to signing any contracts.

LANDOWNER'S GOALS

- Prevent damage to land
- Insure receipt of fair share of production

LEASES ARE NEGOTIABLE

- No standard lease form
- Lease provisions negotiable
- Landowner's ability to negotiate varies

GRANTING CLAUSE

- Outlines purpose of lease
- Describes substances
- Determines criteria for mineral ownership
- Specifies minerals covered

SURFACE OPERATIONS

- Criteria for ownership—surface or minerals
- Negotiable clauses:
  —surface cannot be destroyed
  —identifies substances
  —royalty clause varies as to substance

LIMITING SURFACE OPERATIONS

- Negotiate limits to surface operations:
  —restrict construction
  —negotiate placement of underground transmission lines
  —specify company's structures and equipment must be removed or be forfeited
  —identify liabilities for fences, gates

DURATION CLAUSE

- Primary term
  1) Set number of years negotiated in lease
  2) May require annual delay rental payments

- Secondary term
  1) Commences end of primary term
  2) Lasts as long as drilling continues or minerals are produced

SHUT-IN PROVISIONS

- Allows lease to remain in effect when gas from a producing well is not being sold or used
- Requires a negotiated shut-in royalty be paid annually after end of primary term

DRY-HOLE PROVISIONS

- Effective prior to the discovery of oil and gas
- May extend primary term
- Requires recommencement of drilling within a certain period of time or the payment of delay rentals

CESSATATION-OF-PRODUCTION PROVISIONS

- Effective after the discovery of oil and gas
- May extend either primary or secondary term
- Requires recommencement of drilling within a certain period of time or the payment of delay rentals during the primary term

SHUT-IN CLAUSE

- Extends lease whenever well shut-in
- Negotiable points:
  —limit number of years well can be shut-in
  —require shut-in royalty both during primary and secondary terms
  —escalate shut-in royalties for each year well shut-in
  —specify circumstances when can be shut-in

NEGOTIATING THE ROYALTY CLAUSE

- Allows landowner portion of substance produced
- Specifies deductible costs
- Identifies expenses paid

DETERMINING HOW ROYALTY PAYMENT IS VALUED OR RECEIVED

Three Most Common Methods of Royalty Payment:

- Market Price
  Mineral value as reflected by marketplace
- Proceeds
  Actual revenue derived from the sale of mineral
- In-Kind
  Landowner takes in-kind share and seeks a market outlet

ADDITIONAL ROYALTY NEGOTIATIONS

- Specify time, place, frequency of royalty payments
- Cover payments for negligence, fire or leakage
- Consider overriding royalty
- Determine access to free water, oil, gas

CLARIFICATION OF SURFACE DAMAGES

- Negotiable clauses:
  —require compensation for all surface damages
  —restore land to original condition
  —decide extent of damages
  —specify division of compensation

POOLING CLAUSE— VOLUNTARY POOLING

- Negotiable clauses:
  —require written consent
  —stipulate maximum acres
  —limit pooling to producing strata
  —include a Pugh Clause

ASSIGNMENT CLAUSE

- Negotiable clauses:
  —require written consent or written notification
  —hold original lease holder liable for default
  —identify governing lease with each payment

WARRANTY CLAUSE

- Binds landowner to defend title
  —subjects landowner to litigation expense
  —limits to liability are negotiable

LESSEE'S RIGHTS TO OIL, GAS AND FREE WATER

- Negotiable clauses:
  —place limit on use of free oil and gas
  —restrict water taken from wells, tanks, ponds
  —prohibit use of potable water
  —establish price of purchased water

FORCE MAJEURE CLAUSE

- Suspends lease for reasons beyond lessee's control
- Negotiable clauses:
  —avoid using "force majeure" term . . . use simple terms
  —require written notice
  —specify time in which operations must resume

ADDITIONAL NEGOTIABLE CLAUSES

- Lease each strata separately
- Note whether land can be used for underground storage
- Seek access to books, records and drilling data
- Assume control of casing when operations abandoned
- Negotiate indemnity provisions for lessor

THE FINAL AGREEMENT

- No lease includes all desired clauses
- Granting a lease is a process of negotiation

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